

Department of Education

**For the Year Ended
June 30, 2002**

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**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**

State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

March 27, 2003

The Honorable Phil Bredesen, Governor

and

Members of the General Assembly

State Capitol

Nashville, Tennessee 37243

and

The Honorable Lana Seivers, Commissioner

Department of Education

Suite 600, Andrew Johnson Tower

Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Education for the year ended June 30, 2002.

The review of management's controls and compliance with policies, procedures, laws, and regulations resulted in certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
02/089



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT**

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January 17, 2003

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Education for the year ended June 30, 2002.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of management controls relevant to the audit and that we design the audit to provide reasonable assurance of the Department of Education's compliance with the provisions of policies, procedures, laws, and regulations significant to the audit. Management of the Department of Education is responsible for establishing and maintaining internal control and for complying with applicable laws and regulations.

Our audit disclosed certain findings, which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the department's internal controls and/or instances of noncompliance to the Department of Education's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AH/th

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Education
For the Year Ended June 30, 2002

AUDIT SCOPE

We have audited the Department of Education for the period July 1, 2001, through June 30, 2002. Our audit scope included those areas material to the *Tennessee Comprehensive Annual Financial Report* for the year ended June 30, 2002, and the *Tennessee Single Audit Report* for the same period: the Class Size Reduction program, the Title I Grants to Local Education Agencies, Innovative Education Program Strategies, and the Vocational Education-Basic Grants to States. In addition to those areas, our primary focus was on management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, the Education Trust Fund, the Advisory Council for the Education of Students with Disabilities, utilization of the Department of Finance and Administration's State of Tennessee Accounting and Reporting System (STARS) grant module to record the receipt and expenditure of federal funds, compliance with the Department of Finance and Administration's guidelines for uniform monitoring of subrecipients, and the Qualified Zone Academy Bond Program. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

AUDIT FINDINGS

The Department Needs to Improve Areas of Deficiency and Noncompliance Over Subrecipient Monitoring

The department has not assigned accountability to ensure that corrective action is taken on findings from audits of subrecipients performed in accordance with OMB Circular A-133. In addition, a lack of internal control was noted during the monitoring testwork for the

Innovative Education Program Strategies program. Also, the department did not communicate to subrecipients the Catalog of Federal Domestic Assistance number for the Innovative Education Program Strategies, Class Size Reduction, and Vocational Education-Basic Grants to States programs (page 9).

Composition of the Advisory Council for the Education of Students With Disabilities Was Not in Compliance With State Law

The majority of the members of the Advisory Council for the Education of Students with Disabilities were not individuals with disabilities or parents of children with disabilities as required by Section 49-10-105, *Tennessee Code Annotated* (page 12).

The Qualified Zone Academy Bond Program Does Not Have Adequate Controls

There are no written procedures outlining the responsibilities concerning the administration of the Qualified Zone Academy Bond Program. In addition, the controls over the program are inadequate (page 16).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of Education
For the Year Ended June 30, 2002

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Department of Education

For the Year Ended June 30, 2002

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Education. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

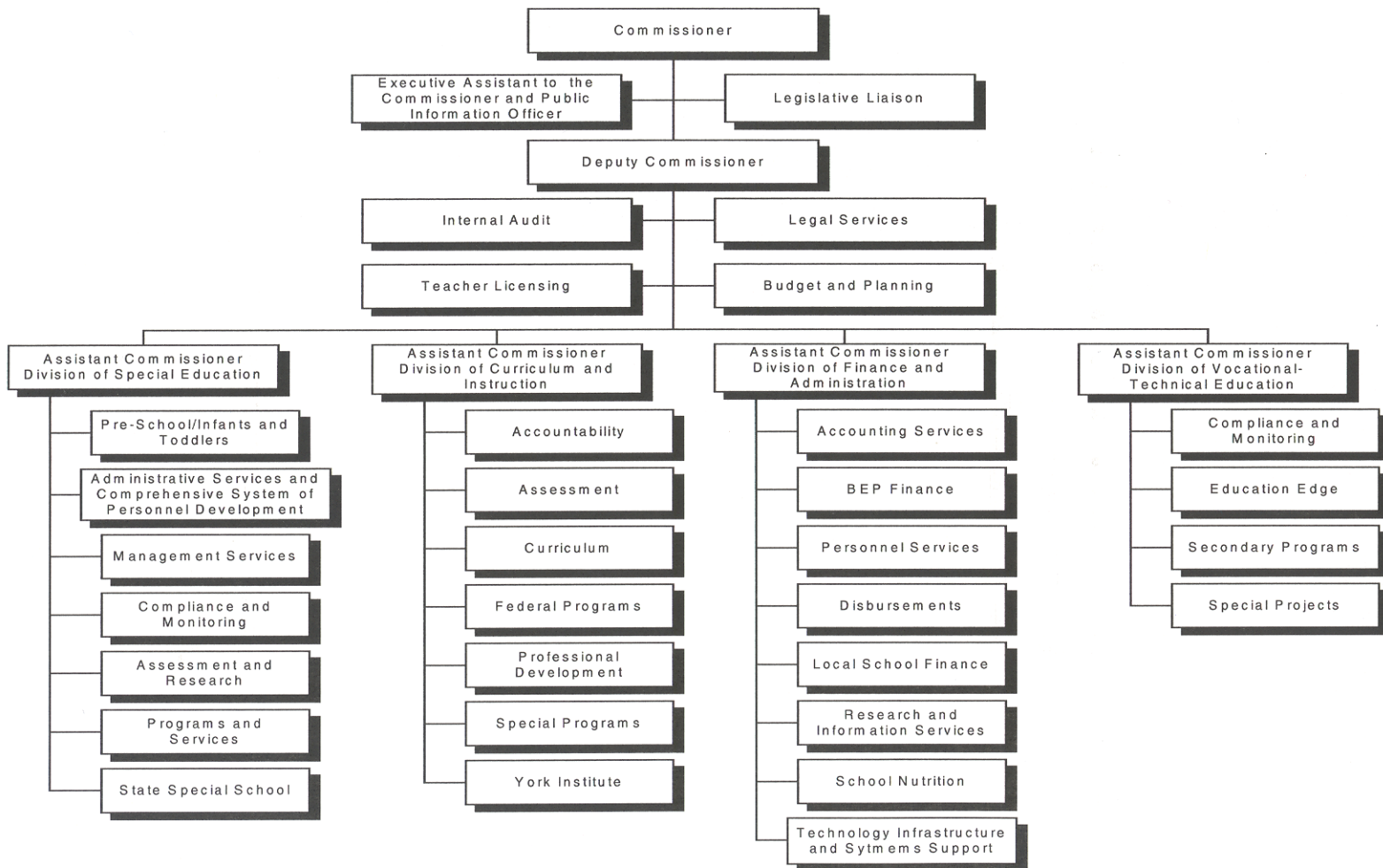
The mission of the Department of Education is to advance student success by creating and supporting a dynamic, world-class system of teaching and learning for all Tennesseans. To fulfill this mission, the department carries out its mandate through an administrative staff and three major divisions: the Division of Curriculum and Instruction, the Division of Vocational Education, and the Division of Special Education.

The department provides technical assistance and monitoring on a statewide basis through its central office and six field offices. The department allocates state and federal funds to the 138 school districts in Tennessee, which annually serve approximately 896,500 students and employ more than 65,800 teachers, principals, supervisors, and other professional employees statewide.

The department’s initiatives for the 2001-2002 school year include merging the state and federal accountability systems for schools and school systems, reducing the disparity in student achievement among subgroup populations, holding school systems fiscally accountable through a system of penalties for late submission of data, and realigning department resources for effective implementation of the federal No Child Left Behind legislation.

An organization chart of the department is on the following page.

Department of Education Organization Chart



AUDIT SCOPE

We have audited the Department of Education for the period July 1, 2001, through June 30, 2002. Our audit scope included those areas material to the *Tennessee Comprehensive Annual Financial Report* for the year ended June 30, 2002, and the *Tennessee Single Audit Report* for the same period: the Class Size Reduction program, the Title I Grants to Local Education Agencies, Innovative Education Program Strategies, and the Vocational Education-Basic Grants to States. In addition to those areas, our primary focus was on management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, the Education Trust Fund, the Advisory Council for the Education of Students with Disabilities, utilization of the Department of Finance and Administration's State of Tennessee Accounting and Reporting System (STARS) grant module to record the receipt and expenditure of federal funds, compliance with the Department of Finance and Administration's guidelines for uniform monitoring of subrecipients, and the Qualified Zone Academy Bond Program. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Education filed its report with the Department of Audit on July 30, 2002. A follow-up of the prior audit finding was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Department of Education made significant improvements regarding the previous audit findings concerning the inadequacy of controls over the reporting of state expenditures by Local Education Agencies for the Vocational Education-Basic Grants to States program and weak controls over the receipting of cash.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

AREAS RELATED TO TENNESSEE'S COMPREHENSIVE ANNUAL FINANCIAL REPORT AND SINGLE AUDIT REPORT

Our audit of the Department of Education is an integral part of our annual audit of the *Comprehensive Annual Financial Report* (CAFR). The objective of the audit of the CAFR is to render an opinion on the State of Tennessee's general-purpose financial statements. As part of our audit of the CAFR, we are required to gain an understanding of the state's internal control and determine whether the state complied with laws and regulations that have a material effect on the state's general-purpose financial statements.

Our audit of the Department of Education is also an integral part of the *Tennessee Single Audit*, which is conducted in accordance with the Single Audit Act, as amended by the Single Audit Act Amendments of 1996. The Single Audit Act, as amended, requires us to determine whether

- the state complied with rules and regulations that may have a material effect on each major federal financial assistance program, and
- the state has internal control to provide reasonable assurance that it is managing its major federal award programs in compliance with applicable laws and regulations.

We determined that the following areas within the Department of Education were material to the CAFR and to the *Single Audit Report*: the Class Size Reduction program, the Title I Grants to Local Education Agencies, the Innovative Education Program Strategies, and the Vocational Education-Basic Grants to States.

To address the objectives of the audit of the CAFR and the *Single Audit Report* as they pertain to these federal award programs, we interviewed key department employees, reviewed applicable policies and procedures, and tested representative samples of transactions.

We have audited the general-purpose financial statements of the State of Tennessee for the year ended June 30, 2002, and have issued our report thereon dated January 17, 2003. The opinion on the financial statements is unqualified. The *Tennessee Single Audit Report* for the year ended June 30, 2002, includes our reports on the schedule of expenditures of federal awards and on internal control and compliance with laws and regulations.

The audit of the department revealed two findings related to the *Single Audit Report*: the department needs to improve deficiencies in subrecipient monitoring, and the composition of the Advisory Council for the Education of Students with Disabilities is not in compliance with state law.

MAJOR FEDERAL AWARD PROGRAMS

CLASS SIZE REDUCTION

The objective of the Class Size Reduction (CSR) Program is to help schools improve student learning by hiring additional, highly qualified teachers so that children, especially those in the early elementary grades, can attend smaller classes. The addition of these new teachers should result in the reduction of class size in the early grades to an average of 18 children per class. The CSR program also includes a strong emphasis on teacher quality and professional development. Local Education Agencies (LEAs) may use up to 25 percent of their grants on activities in this area.

TITLE I GRANTS TO LOCAL EDUCATION AGENCIES

The objective of the Title I program is to improve the teaching and learning of children who are at risk of not meeting challenging academic standards and who reside in areas with high concentrations of children from low-income families.

INNOVATIVE EDUCATION PROGRAM STRATEGIES

The objectives of the Innovative Education Program Strategies are to (1) assist local educational reform efforts which are consistent with and support statewide reform efforts under the Goals 2000: Educate America Act; (2) support state and local efforts to accomplish the National Education Goals; (3) provide funding to enable State Educational Agencies (SEAs) and Local Education Agencies (LEAs) to implement promising educational reform programs; (4) provide a continuing source of innovation and educational improvement, including support for library services and instructional and media materials; and (5) meet the special educational needs of at-risk and high-cost students.

VOCATIONAL EDUCATION-BASIC GRANTS TO STATES

The objective of the Vocational Education program is to provide grants to states and outlying areas to develop the technical, vocational, and academic skills of secondary students and postsecondary students.

Our audit of these programs consisted of the following areas, as applicable:

- General Internal Control
- Activities Allowed or Unallowed and Allowable Costs/Cost Principles
- Cash Management
- Matching, Level of Effort, Earmarking

- Period of Availability of Federal Funds
- Procurement and Suspension and Debarment
- Federal Reporting
- Subrecipient Monitoring
- Special Tests and Provisions
- Schedule of Expenditures of Federal Awards

The audit objectives, methodologies, and our conclusions for each area are stated below. For each area, auditors documented, tested, and assessed management's controls to ensure compliance with applicable laws, regulations, grants, contracts, and state accounting and reporting requirements. To determine the existence and effectiveness of management's controls, auditors administered planning and internal control questionnaires; reviewed policies, procedures, and grant requirements; prepared internal control memos, performed walk-throughs, and performed tests of controls; and assessed risk.

General Internal Control

Our objectives for general controls were to obtain an understanding of, document, and assess management's general controls. We interviewed key program employees; reviewed organization charts, descriptions of duties and responsibilities for each division, and correspondence from the grantor; and considered the overall control environment of each program. We did not note any significant deficiencies in management's general controls related to the major federal award programs.

Activities Allowed or Unallowed and Allowable Costs/Cost Principles

The objectives for the applicable major federal programs were to determine if funds were used for allowable purposes; federal expenditures were in compliance with grant requirements; and expenditures involving federal funds were recorded correctly as to the applicable federal grant and the proper grant program.

Supporting documentation for all significant items of the major federal programs was reviewed and tested to determine if funds were used for allowable purposes. The significant items were also tested for compliance with grant requirements and appropriate recording to the proper grant program.

We determined that grant funds were spent for allowable activities in compliance with grant requirements and were properly recorded to the applicable federal grant and the proper grant program.

Cash Management

Our objective for the applicable major federal programs was to determine if the department complied with the terms and conditions of the Cash Management Improvement Act Agreement between the state and the Secretary of the Treasury, United States Department of the Treasury (State-Treasury Agreement).

We tested a nonstatistical sample of federal cash drawdown transactions for compliance with the State-Treasury cash management agreement.

We determined that management had complied, in all material respects, with the State-Treasury cash management agreement.

Matching, Level of Effort, Earmarking, and Period of Availability of Federal Funds

Our objectives for the applicable major federal programs were to provide reasonable assurance that matching requirements were met and to provide reasonable assurance that federal funds were used only during the authorized period of availability.

To provide reasonable assurance that matching requirements were met, we examined the State of Tennessee Accounting and Reporting System (STARS) Grant Expenditures by Object reports. We reviewed listings of expenditures charged to grants that closed during the audit period to determine whether the federal funds were used only during the authorized period of availability.

The department appeared to comply with matching requirements, and federal funds appeared to be used only during the authorized period of availability.

Procurement and Suspension and Debarment

Our objectives for the applicable major federal programs were to provide reasonable assurance that procurement of goods and services was made in compliance with the provisions of applicable regulations and guidelines, and that no subaward, contract, or agreement for purchase of goods or services was made with any debarred or suspended party.

We reviewed the OMB Circular A-133 *Compliance Supplement* for internal control and compliance requirements for procurement and suspension and debarment. In addition, nonstatistical samples of transactions were selected and tested for assurance that no items were purchased from a party that was suspended or debarred.

Management appears to have complied with procurement requirements, including requirements concerning debarred and suspended parties.

Federal Reporting

Our objective for the applicable major federal programs was to ensure that reports of federal awards submitted to the federal awarding agency included all activity of the reporting period, were supported by underlying accounting or performance records, and were submitted in accordance with program requirements.

We asked management about the requirements and procedures for preparing, reviewing, and submitting program financial and progress reports. We selectively tested the mathematical accuracy of the reports, reviewed supporting documentation for the information presented, and determined if the reports were prepared in accordance with grant guidelines and requirements.

In all material respects, reports of federal awards appeared to include all activity of the reporting period, were supported by underlying records, and were submitted in accordance with program requirements.

Subrecipient Monitoring

Our objective for the applicable major federal programs was to determine whether subrecipients (Local Education Agencies) were properly monitored to ensure compliance with federal award requirements.

We asked management about procedures for monitoring subrecipients and tested nonstatistical samples to determine if subrecipients were adequately monitored and if an audit in accordance with OMB Circular A-133 had been performed.

We determined that the department needed to improve deficiencies in subrecipient monitoring, as discussed in finding 1.

Special Tests and Provisions

Specific requirements for special tests and provisions for applicable major federal programs were obtained by review of the OMB Circular A-133 *Compliance Supplement*; interviews with key employees; and review of laws, regulations, and the provisions of contract or grant agreements pertaining to specific programs. Where applicable, nonstatistical samples were selected.

The department appears to have complied with all special tests and provisions requirements tested.

Schedule of Expenditures of Federal Awards

Our objective was to verify that the Schedule of Expenditures of Federal Awards was properly prepared and adequately supported. We verified the grant identification information on the Schedule of Expenditures of Federal Awards, and total disbursement amounts were traced to supporting documentation. We determined that the Schedule of Expenditures of Federal Awards was properly approved and adequately supported.

Finding, Recommendation, and Management's Comment

1. The department needs to improve areas of deficiency and noncompliance over subrecipient monitoring

Finding

A review of the Department of Education's monitoring of subrecipients revealed areas of deficiency and instances of noncompliance with federal regulations.

The department has not assigned accountability to ensure that corrective action is taken on findings from audits of subrecipients performed in accordance with OMB Circular A-133. According to OMB Circular A-110, paragraph .51(a), "Recipients are responsible for managing and monitoring each project, program, subaward, function, or activity supported by the award. Recipients shall monitor subawards to ensure subrecipients have met the audit requirements." Also, according to the A-133 *Compliance Supplement*, a pass-through entity is responsible for "ensuring required audits are performed and requiring the subrecipient to take prompt corrective action on any audit findings." The department could not provide audit reports for 8 of 25 Local Education Agencies (LEAs) (32%) tested.

In addition, a lack of internal control was noted during the monitoring testwork for the Innovative Education Program Strategies program. The department requires all LEAs to send an annual self-monitoring report to regional consultants throughout the state. The LEAs use the monitoring report to document areas of noncompliance, and the regional consultants follow up on each area noted. The department groups the LEAs by region into East Tennessee, Middle Tennessee, or West Tennessee and requires the regional consultants to forward one-third of the LEA monitoring reports to the department to document that monitoring has occurred and to ensure that any deficiencies noted in the report have been corrected. Testwork revealed several problems. (1) Monitoring reports submitted by the regional consultant for West Tennessee did not agree with the department's listing of the LEAs to be monitored. (2) The department's listing of LEAs did not agree with the regional consultant's listing for the Middle Tennessee region. (3) Two LEAs designated by the department as being in the East Tennessee region and whose reports were required to be submitted to the department in fiscal year 2002 were designated as being in the Middle Tennessee region on the consultant's listing. In addition, the consultant's listing showed the year of submission as fiscal year 2001 for one of the LEAs and fiscal year 2000 for the other LEA. (4) A Middle Tennessee LEA report designated by the department as being due for submission in fiscal year 2002 was designated on the consultant listing as being due for submission in fiscal year 2001.

Finally, the department did not communicate the Catalog of Federal Domestic Assistance (CFDA) number to subrecipients for the Innovative Education Program Strategies, Class Size Reduction, and Vocational Education-Basic Grants to States programs, as required by OMB Circular A-133.

Recommendation

The department should assign the responsibility of obtaining audit reports, reviewing subrecipient audit findings, and ensuring that subrecipient audit findings are corrected. In addition, the department should improve communications with regional consultants to ensure that the correct monitoring reports are submitted. The department should communicate to all subrecipients the CFDA numbers for federal programs passed through to the subrecipients.

Management's Comment

We concur. Responsibility for obtaining audit reports and review of audit findings for corrective action will be assigned to finance staff. Communications between regional consultants and school districts will be improved to assure compliance with federal regulations.

REVENUE

Our objectives for reviewing revenue controls and procedures were to determine whether

- policies and procedures relating to revenue were adequate,
- funds were properly controlled and deposited intact,
- funds were deposited in a timely manner,
- the department maintained proper documentation for each journal voucher,
- transactions were properly documented,
- receipts agreed with amounts deposited,
- deposit slips were properly completed, and
- departmental records were reconciled with STARS (State of Tennessee Accounting and Reporting System).

We reviewed the applicable laws and regulations, interviewed key department personnel, and reviewed supporting documentation to gain an understanding of the controls and procedures over revenues. We reviewed reconciliations of revenue records with revenue reports. We also tested a nonstatistical sample of revenue transactions and a nonstatistical sample of cash receipts.

Based on interviews and a review of internal controls, we determined that policies and procedures related to revenue were adequate; that transactions were properly documented; that

receipts agreed with amounts deposited; that deposits were completed properly; that departmental records were reconciled with STARS; and that funds were properly controlled, deposited intact, and deposited in a timely manner. We also determined that proper documentation was maintained for each journal voucher.

EXPENDITURES

Our objectives for reviewing expenditure controls and procedures were to determine whether

- policies and procedures regarding expenditures were adequate,
- expenditures were properly approved,
- the department maintained proper documentation for each journal voucher,
- evidence exists that goods were received,
- invoices were mathematically accurate,
- signatures on supporting documentation were made by authorized individuals,
- documentation was sufficient to support payment of the invoice, and
- bids were solicited when needed.

We reviewed the applicable laws and regulations, interviewed key department personnel, and reviewed supporting documentation to gain an understanding of the controls and procedures over expenditures. We also tested all significant expenditure transactions and a nonstatistical sample of other expenditure transactions.

Based on interviews and a review of internal controls, we determined that policies and procedures regarding expenditures were adequate, that expenditures were properly approved by authorized personnel, that the department maintained proper documentation for journal vouchers, that evidence existed that goods were received, that invoices were mathematically accurate, that documentation was sufficient to support payment of the invoice, and bids were solicited when needed.

EDUCATION TRUST FUND

Our objective for reviewing the education trust fund was to determine whether the financial statements, which are included in the state's *Comprehensive Annual Financial Report*, were fairly stated, properly supported, and comparable to the prior-year financial statements.

We recalculated the financial statements to determine their accuracy, traced amounts to the State of Tennessee Accounting and Reporting System, and verified account classifications. We compared the current-year financial statements with the prior-year financial statements to determine any reporting changes. We also compared the amounts between current-year financial statements and prior-year financial statements and obtained explanations for any significant variances.

We determined that the financial statements were fairly stated, properly supported, and comparable to the prior-year financial statements.

ADVISORY COUNCIL FOR THE EDUCATION OF STUDENTS WITH DISABILITIES

Our objective for reviewing the Advisory Council for the Education of Students with Disabilities was to determine if the composition of the council was in compliance with state law.

We interviewed key department personnel and reviewed supporting documentation for each member of the council.

We determined that the composition of the council was not in compliance with state law, as discussed in finding 2.

Finding, Recommendation, and Management's Comment

2. **The composition of the Advisory Council for the Education of Students with Disabilities was not in compliance with state law**

Finding

The majority of the members of the Advisory Council for the Education of Students with Disabilities were not individuals with disabilities or parents of children with disabilities as required by Section 49-10-105, *Tennessee Code Annotated*. The law states that “. . . the majority of the advisory council shall be individuals with disabilities or parents of children with disabilities.” A review of council members as of November 11, 2002, revealed that 10 of 16

council members (62.5%) were neither an individual with disabilities nor a parent of a child with disabilities. The Governor appoints the advisory council members.

Recommendation

The department should continue to monitor the composition of the Advisory Council for the Education of Students with Disabilities, and if the composition is not in compliance with state law, the Governor's office should be notified.

Management's Comment

We concur. The department will continue to monitor the composition of the Advisory Council for compliance with state law. The department will continue to communicate with the Governor's Office on the need for appropriate appointments to the council.

DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 20, "RECORDING OF FEDERAL GRANT EXPENDITURES AND REVENUES"

Department of Finance and Administration Policy 20 requires that state departments whose financial records are maintained on the State of Tennessee Accounting and Reporting System (STARS) fully utilize the STARS Grant Module to record the receipt and expenditure of all federal funds. Our testwork focused on whether

- appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and related revenue and expenditure transactions were coded with the proper grant codes;
- the department made drawdowns at least weekly using the applicable STARS reports;
- the department had negotiated an appropriate indirect cost recovery plan, and indirect costs were included in drawdowns; and
- the department utilized the appropriate STARS reports as bases for preparing the schedule of expenditures of federal awards and reports submitted to the federal government.

We interviewed key personnel to gain an understanding of the department's procedures and controls concerning Policy Statement 20. We performed testwork to determine if appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and if related revenue and expenditure amounts were coded with the proper grant codes. We performed testwork to determine if the department made drawdowns at least

weekly using the applicable STARS reports, if the department had negotiated an appropriate indirect cost recovery plan, and if indirect costs were included in drawdowns. We also performed testwork to determine if the appropriate STARS reports were used as bases for preparing the schedule of expenditures of federal awards and reports submitted to the federal government.

Based on our interviews, reviews of supporting documentation, and testwork, we determined that the appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and that related revenue and expenditure transactions were coded with the proper grant codes. We determined that the department made drawdowns at least weekly using the applicable STARS reports. We determined that the department had negotiated an appropriate indirect cost recovery plan, and indirect costs were included in drawdowns. We also determined that the department utilized the appropriate STARS reports as bases for preparing the schedule of expenditures of federal awards and reports submitted to the federal government.

DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 22, “SUBRECIPIENT MONITORING”

Department of Finance and Administration Policy 22 establishes guidelines for uniform monitoring of subrecipients that receive state and/or federal funds from state departments, agencies, and commissions. Our testwork focused on

- the criteria used to distinguish between subrecipients and vendors,
- the department’s method for risk assessment,
- determining whether the risk assessment method targeted areas that helped identify the subrecipient’s risk level, and
- determining whether the risk assessment method was properly and consistently applied to the subrecipients.

We interviewed key personnel and reviewed supporting documentation to gain an understanding of the department’s procedures and controls concerning Policy Statement 22. We selected a listing of payees to determine whether payees not listed as subrecipients were appropriately classified as vendors. We reviewed the method used for risk assessment to determine whether the risk assessment targeted areas that identified the subrecipients’ risk level. We also reviewed the risk assessment method to determine if the method was properly and consistently applied to the subrecipients.

We determined that the department’s procedures and controls concerning Policy 22 appeared adequate. We determined that payees not listed as subrecipients were appropriately

classified as vendors. We determined that the method used for risk assessment targeted areas that identified the subrecipients' risk level, and we determined that the risk assessment method was properly and consistently applied to the subrecipients.

QUALIFIED ZONE ACADEMY BOND PROGRAM

The Qualified Zone Academy Bond Program (QZAB), a federal program designed to issue bonds to provide zero-interest loans to qualifying local public school systems, is administered jointly by the Division of Local Finance of the Department of Education (the Department) and the Tennessee State School Bond Authority (the Authority). The program is governed by Section 1397E of the Internal Revenue Code and Title 49, Chapter 3, *Tennessee Code Annotated*.

The primary objectives of our review of the QZAB program at the Department (and also at the Authority) were to

- obtain and document an understanding of management's controls and procedures,
- assess the adequacy of the controls and procedures for ensuring compliance with applicable laws and regulations,
- evaluate the existence and effectiveness of management's controls and procedures by determining compliance with the controls and procedures, and
- test compliance with applicable laws and regulations.

We reviewed applicable laws and regulations relating to the QZAB program to determine the requirements for the program. We interviewed key Department and Authority employees to gain an understanding of the policies and procedures surrounding the program. In addition, we performed testwork on a representative sample of QZAB transactions.

Our testwork did not identify any significant financial transactions that were not in compliance with applicable laws and regulations. However, based on our review, interviews, and testwork, it appears that the Qualified Zone Academy Bond Program has not developed, documented, or implemented adequate controls or procedures as discussed in finding 3.

Finding, Recommendation, and Management's Comment

3. The Qualified Zone Academy Bond Program does not have adequate controls

Finding

Neither the Department of Education (the Department) nor the Tennessee State School Bond Authority (the Authority) has developed written procedures outlining the responsibilities of each entity concerning the administration of the Qualified Zone Academy Bond Program (QZAB), a federal program designed to issue bonds to provide zero-interest loans to qualifying local public school systems. The bondholders receive a tax credit in lieu of interest payments. Due to the tax implications, Section 1397E of the Internal Revenue Code (IRC) established and regulates this program. In order for a local public school system to be considered to be eligible for this program, it must qualify as a Qualified Zone Academy. As defined by the IRC, a Qualified Zone Academy must meet several criteria, including having the expectation that 35 percent or more of the students within the school qualify for the free or reduced-cost lunch program. The IRC also establishes restrictions for the use of bond proceeds and requires involvement from the community in which the academy is located. On the state-level, the QZAB program is administered jointly by the Department and the Authority. Bond proceeds are distributed to the borrowers on a reimbursement basis. The borrowers (mostly county or city public schools) make qualified expenses, provide documentation to the Department, and are reimbursed by the Authority. Section 49-3-1206 (d) (1), *Tennessee Code Annotated*, states that the Department and the Authority “shall develop the application and review procedure for loans under the program.” Based on our review, controls over the QZAB program are not adequate, and as a result, several problems were noted.

Complete applicant files are not maintained for the approved loans. In the file of one of the ten approved loans, the loan that was awarded per the official bond documents was \$5 million. However, the requested loan amount on the application on file was \$2.5 million, only half of the amount eventually awarded the borrower. Documentation to support the increased loan amount was not available.

Errors were also noted in the reimbursement requests paid by the Authority. For four of ten reimbursement requests tested (40%), invoices were missing, inadequate, or not properly computed. For two of these items, the requests slightly exceeded the total of the supporting invoices. One request exceeded the attached invoices by \$6.90, while the other request exceeded the attached invoices by \$466.11. One request contained 30 documents apparently generated internally from the borrower's accounting system rather than vendor invoices. These documents were the only support provided for the \$9,650.82 expense that was reimbursed by the Authority. Furthermore, the copy of the attached vendor invoices for another request did not include all line items on the original invoice; therefore, the mathematical accuracy of the request could not be tested. The missing invoices totaled \$103.60.

The incorrect object code was used to process the reimbursement requests in the State of Tennessee accounting system. The object code for Construction of Buildings (new construction and additions) was used although new construction is specifically prohibited by federal and state QZAB regulations. Based on our review of the vendor invoices, other object codes would have been more accurate. The types of expenses noted did not appear to be prohibited by QZAB regulations. In addition, the form used when submitting reimbursement requests requires the signature of the local official responsible for the project before submission to the Director of Local School Finance at the Department of Education. The local official responsible for the project did not sign the request in one of the ten requests tested (10%).

Recommendation

The Tennessee State School Bond Authority and the Department of Education should develop a written agreement defining the responsibilities of each entity. The Department, in conjunction with the Authority, should then develop policies and procedures outlining the guidelines to be followed with respect to the administration of the program. The guidelines should include sufficient procedures to ensure that the activities of the program are adequately controlled and documented. These guidelines should also include a comprehensive process to ensure that the requests are for qualified expenses and that these expenses are fully supported by vendor invoices. The process should ensure that the required approvals have been obtained prior to the reimbursement of loan funds. The guidelines should also ensure that the requests are coded correctly within the state's accounting system. Finally, complete files should be maintained on each borrower until the bonds are repaid.

Management's Comments

Department of Education

We concur. Guidelines will be developed defining the responsibilities of the Tennessee State School Bond Authority and the Department of Education. Policies and procedures will be developed outlining the administration of the program.

Tennessee State School Bond Authority

We concur. We will work with the Department of Education to establish procedures and lines of responsibility relating to the administration of the program. We will also work with the Department of Finance and Administration to establish meaningful object codes for the types of invoices that we process.

OBSERVATIONS AND COMMENTS

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Tennessee Code Annotated, Section 4-21-901, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by each June 30. The Department of Education filed its compliance report and implementation plan on July 26, 2002.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Human Rights Commission is the coordinating state agency for the monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

APPENDIX

DIVISIONS AND ALLOTMENT CODES

Department of Education divisions and allotment codes:

331.01	Division of Administration
331.02	Grants-in-Aid
331.03	Elementary and Secondary Education System Act, Titles I, II, VI
331.04	Technology Infrastructure and Systems Support
331.05	Training and Professional Development
331.06	Curriculum and Instruction
331.07	State Board of Education
331.09	Improving School Programs
331.10	Career Ladder Program
331.11	Accountability
331.12	Goals 2000, Educate America Act/Technology Literacy
331.25	Basic Education Program
331.35	School Nutrition Programs
331.36	Special Education Services
331.43	State Driver Education
331.45	Vocational Education
331.90	Alvin C. York Agricultural Institute
331.91	Tennessee School for the Blind
331.92	Tennessee School for the Deaf–Knoxville
331.93	West Tennessee School for the Deaf–Jackson
331.95	Tennessee Infant and Parent Services
331.97	Major Maintenance